decision of the directors. It insulates these decisions from judicial review, absent fraud, illegality or bad faith, as long as the director exercised informed business judgment. Willful blindness is not acceptable, however. The Delaware Supreme Court in ***Smith v. Van Gorkom***[6] stated that the Business Judgment Rule does not protect directors who breach their duty of care by not making informed decisions.

2. Duty of Loyalty/Fidelity

A director must exercise his or her powers in the best interest of the corporation and not in the director's personal interest or in the interest of another person.[7] The director should not use a corporate position for personal gain at the expense of the corporation. The duty of loyalty arises in various situations[8] to prohibit forms of self-dealing and misappropriation of corporate assets. For example, in ***Nixon v. Lichtenstein,***[9] the attorney general sued and removed two directors who breached their fiduciary duties by causing the corporation to pay their personal obligations. The fiduciary standard is even higher when significant business decisions, such as a conversion or merger, are involved.

The Delaware Supreme Court has concluded in two leading cases that directors have special obligations in the sale/merger of a corporation.[10] In this context, directors must act reasonably to find the best offer available to the company. In deciding if the directors have acted reasonably, courts will look at how the directors have come to their decision,

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6 488 A. 2d 859 (Del. 1985).

7 *See* notes/annotations accompanying 8 Del. Code Ann. §141; Md. Code Ann §2-419; Va. Stat. Ann. 13.1-694 (discussing Virginia's duty of fidelity). The D.C. Code contains no direct references to the duty of loyalty, *but see* Wisconsin Ave. Associates, Inc. v. 2720 Wisconsin Ave. Co-op, 441 A. 2d 956 (D.C., 1982) (discussing directors' fiduciary duties to the corporation including the duty of loyalty).

8 For example, in situations involving interested director transactions, interlocking boards, corporate opportunity and confidentiality.

9 959 S.W. 2d 854 (Missouri Court of Appeals, 1997).

10 *See, e.g.,* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A. 2d 173 (Del. 1986); Paramount Communications, Inc. v. QVC Network, Inc., 637 A. 2d. 34 (Del. 1994).

and whether that decision is reasonable in the context of those circumstances. The process followed in making the decision must be fair and the price obtained for the corporation must also be fair. In this context, Delaware courts have applied a more rigorous standard than the Business Judgment Rule, mentioned in the previous section, to the sale of a corporation. If the more rigorous standard applies, courts not only look to see if the board of directors used due care in preparing itself to make decisions and whether the decisions were tainted by self-dealing, but also determine whether the board's decisions were reasonably calculated to achieve a legitimate corporate objective.

The leading case in which this heightened standard was applied was *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). When the *Revlon* standard applies, the board of directors is required to obtain the best possible price for the shareholders, and many factors that a board ordinarily is permitted to consider (*e.g.* the interests of employees, customers or the communities in which the corporation does business) can no longer properly be taken into account. However, *Revlon* primarily applies to situations where there has been a "change in control", *i.e.*, when the shareholders are losing, once and for all, their opportunity to obtain a control premium. For example, *Revlon* does not apply to a board of directors' decision to enter into a stock-for-stock merger in which the shareholders of their corporation will continue as full equity participants in the ongoing post-merger venture.[11]

Since any possible transaction between CareFirst and another Blue Cross Blue Shield Plan would involve a stock-for-stock merger or share exchange, it is unlikely that a court would conclude that *Revlon* would apply to the merger. Two cases have applied the heightened *Revlon* standard to stock-for-stock mergers[12] where it would not otherwise apply, but only because deal protective measures such as "no shop" provisions in the cases were so restrictive that they limited the ability of the directors to fulfill their fiduciary duties by considering better offers. Other cases, decided both before and after *Phelps* and *ACE*, applied the Business Judgment Rule, and not the heightened *Revlon*

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[11] *See generally* Paramount Communications, Inc. v AVC Network, Inc., 637 A.2d 34 (Del. 1994).

[12] *See* Phelps Dodge Corp. v. Cyprus Amax Minerals Co., C.A. No. 17398 (Del. Ch. Sep. 27, 1999); ACE Ltd. v. Capital Re Corp., 747 A.2d 95 (Del. Ch. 1999). Both cases suggested that, at least under certain circumstances, "no shop" provisions that are so strict that they prevent the board of directors from speaking to other potential bidders may be invalid, even in connection with transactions that do not constitute changes in control.

standard, to deal protection measures contained in agreements for stock-for-stock mergers and suggested that such provisions were valid, even those containing "no-shop" provisions that prevent the board of directors from speaking to other potential bidders.[13] Thus, as long as CareFirst does not enter into any overly restrictive deal protection measures[14] that may try to limit the fiduciary duties owed by the directors, it appears that the Business Judgment Rule, and not the heightened *Revlon* standard, would apply to a possible CareFirst transaction.

Further evidence that the *Revlon* standards would not apply to a CareFirst transaction is the fact that to date, no court has applied *Revlon* to the board of directors of a not-for profit, either in the context of a conversion or a merger. Although some commentators have tried to make the case that *Revlon* should apply to not-for-profit boards[15], the CareFirst board may rely on the fact that no court has adopted this view.

As mentioned above, in a context where *Revlon* duties are applicable, a board of directors must abandon consideration of non-price factors in favor of obtaining the best price for the corporation's shareholders. In a context where *Revlon* does not apply, non-price factors may be considered by the board in the exercise of its business judgment as part of the process of determining whether a particular offer is in the best interest of the corporation.

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[13] *See* G. Varallo & S. Raju, *A Process Based Model for Analyzing Deal Protection Measures*, 55 BUS. LAW. 1609, 16198-35 (2000).

[14] *See ACE*, 747 A.2d at 107 (citing Paramount Communications Inc. v QVC Networks Inc, 637 A.2d 34 (Del. Supr. 1994). The court noted that QVC does not say that a board can, in all circumstances, continue to support a merger agreement not involving a change in control when: 1) the board negotiated a merger agreement that was tied to voting agreements ensuring consummation if the board does not terminate the agreement; 2) the board no longer believes that the merger is a good transaction for the stockholders; and 3) the board believes that another available transaction is more favorable to the stockholders. The fact that the board has no *Revlon* duties does not mean that it can contractually bind itself to sit idly by and allow an unfavorable and preclusive transaction to occur that its own actions have brought about. *Id.*

[15] *See* Colin Moran, *Why Revlon Applies to Nonprofit Corporations*, 33 BUS. LAW. 373 (1998) (arguing that state law already presupposes that Revlon duties apply to nonprofit boards and that Revlon duties would redress the problem of self-dealing in the nonprofit context as well as they did in the for-profit context).

a. Conflicts of Interest

In the context of a possible merger, the duty of loyalty would require disclosure of any possible conflicts of interest if the director directly or indirectly may have an interest in the transaction, financial or otherwise, that might be considered to conflict with the best interests of the corporation. For example, a director may have an employment or investment relationship with the potential merger partner, may have a family relationship with a principal in such an entity, or may be providing professional services to such entity. Other possible conflicts of interest are the receipt of offers of employment from the potential merger partner, ownership interest in the potential merger partner, or receipt of payments not to compete. All directors should be sensitive to these potentially conflicting relationships and must act with candor and care in dealing with such situations.

A transaction involving an interested director is not voidable solely because the director participates in the meeting which authorizes the transaction, even if the interested director's vote is counted, if: (1) the transaction is approved by a majority of disinterested directors, (2) the material facts about the director's interest are disclosed and the transaction is approved by shareholders, or (3) the transaction is fair to the corporation at the time it was authorized, approved or ratified.[16] Any transaction that is not deemed fair and reasonable will be voidable by the corporation.

b. Interlocking Boards

In the context of a conversion and business combination, the CareFirst directors should be sensitive to the structural conflicts of the holding company system, particularly when a director sits on more than one CareFirst board. Directors who act in a dual capacity owe the same duty of care to both corporations and must exercise this duty in light of what is best for both corporations. If potential merger partners have common directors, that circumstance would be considered in testing the validity and good faith of the transactions between them.

II. Fiduciary Duties in the context of the CareFirst Transaction

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[16] Del Code Ann. Gen. Corp. Law §144; Md. Code Ann. Corps. & Ass'ns §2-419. D.C. does not have a similar provision.

The above standards are more or less straightforward; however their application in the context of a possible CareFirst transaction is more difficult. Because the corporation has no shareholders, the director's duties are potentially owed to policyholders, members, insureds and other groups, depending on the statute. What follows in Part A highlights the relevant statutory sections and discusses the various fiduciary duties they raise. Part B examines some of the relevant case law and the conclusions to be drawn therefrom.

A. Statutory Standards

1. Maryland

In the context of converting[17] CareFirst to a for-profit entity, a number of review criteria of the Maryland Insurance Administration (the "Administration") reflect criteria the Directors themselves should consider.

The Administration will not approve acquisitions/conversions that are not in the public interest. An acquisition is deemed not to be in the public interest unless (among other things) steps have been taken to ensure that the value of the public or charitable assets is safeguarded. SG §6.5-301(a). Among other factors that the Administration considers when determining if an acquisition is in the public interest are: 1) whether the transferor exercised due diligence in all aspects of the transaction; 2) whether appropriate decision-making procedures were used; 3) whether any conflicts of interest on the part of the executives and directors were disclosed; 4) whether the transferor will receive fair market value for its assets; and 5) whether the acquisition will likely have an adverse effect on the availability or accessibility of health care services in the affected community and whether those affected will have continued access to affordable health care. SG6.5-301(e).

In deciding whether to approve the acquisition/conversion of a nonprofit health service plan, the Administration must also consider: 1) whether the acquisition is in the public interest; 2) whether the acquisition is equitable to enrollees, insureds, shareholders,

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[17] Title 6.5 of the State Government Article of the Annotated Code of Maryland (1999 Replacement Volume) includes "a conversion to a for-profit entity" in its definition of acquisition. SG §6.5-101(b).

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and certificate holders;[18] 3) whether the acquisition is approved by at least two-thirds of the nonprofit entity's certificate holders who have voted on the acquisition; and 4) whether the acquisition ensures that the entity will comply with the applicable surplus requirement and be able to provide for the security of the certificate holders and policyholders. SG §6.5-303.

In the context of acquiring control of a Maryland Domestic Insurer or Insurance Holding Company, the Administration must also approve, or at least not disapprove, the transaction. The Administration will disapprove a transaction if it finds that (among other items) the financial condition of the acquiring person might prejudice the interests of its policyholders; the acquiring person has plans that are unfair to policyholders; or it would not be in the best interest of the policyholders or public to allow the acquiring person to control the domestic insurer based on the competence, experience and integrity of the persons that would control the operations of the domestic insurer. IN §7-306.

Therefore, in the conversion context it will be extremely important for the directors to consider any aspects of the transaction/conversion/merger that might affect the public interest in an adverse way. In addition, the directors must be especially careful to ensure fairness not only to its members, but to its enrollees, its insureds and its certificate holders. Because disapproval in the context of a merger can ride not only on prejudice to the public interest but also on prejudice to the interest of CareFirst's policyholders, it will also be important for the directors to consider these interests throughout each step of deliberation on the proposed merger.

2. Delaware

Delaware law does not contain any statutes that specifically address the conversion of a nonprofit health services corporation to a for-profit entity. Nevertheless, the Delaware Insurance Commissioner must approve a merger or an acquisition of control of a Delaware domestic insurer. 18 Del. Code §5003. Approval is required unless some negative findings are made such as: 1) the financial condition of the acquiring party might prejudice the interests of the insurer's policyholders[19]; 2) the acquiring person has plans to make material changes in its business/corporate structure or

[18] The Maryland Code does not provide definitions for "enrollees," "insureds" or "certificate holders."

[19] The Delaware Code does not define this term.

management that are unfair and unreasonable to policyholders of the insurer and not in the public interest; 3) the competence, experience and integrity of those persons who would control the operation of the insurer are such that it would not be in the interest of policy holders of the insurer and of the public to permit the merger or other acquisition of control; or 4) the acquisition is likely to be hazardous or prejudicial to the insurance buying public. 18 Del. Code §5003(d)(1).

The issues of concern for directors in Delaware are similar to those in Maryland. Directors must look out for the interests not only of the company's policyholders but of the insurance buying public as well. Again, these interests must be considered throughout the merger process.

3. District of Columbia

A corporation issued a certificate of authority by the Mayor may convert to a for-profit entity under a plan and procedure approved by the Mayor. 35 D.C. Code §4715. The mayor is required to approve any plan or procedure unless the Mayor finds (among other items) that the plan: 1) is inequitable to contractholders of the converting company or to the public or 2) provides that any part of the assets will inure directly or indirectly to any officer, director or trustee of the corporation. 35 D.C. Code §4715(b).

The Mayor is required to approve or disapprove a merger. 35 D.C. Code §3703(g)(2). The District of Columbia's approval standard is much like those of Delaware and Maryland. The Mayor must approve the transaction unless the Mayor makes a negative finding such as: 1) the financial condition of the acquiring party might prejudice the interests of the insurer's policyholders; 2) the acquiring person has plans to make material changes in its business/corporate structure or management that are unfair and unreasonable to policyholders of the insurer and not in the public interest; 3) the competence, experience and integrity of those persons who would control the operation of the insurer are such that it would not be in the interest of policy holders of the insurer and of the public to permit the merger or other acquisition of control; or 4) the acquisition is likely to be hazardous or prejudicial to the insurance buying public. 35 D.C. Code §3703(g)(1).[20]

[20] Note that this provision is identical to 18 Del. Code §5003(d)(1).

As is the case in Maryland and Delaware, directors in the District must look out for the interests of a variety of entities. First, the directors must be sure, in converting, that the plan is fair to contractholders and the general public. Second, the directors cannot gain any part of the assets from the transaction. During the merger, the directors must also look out for the interest of policyholders and the insurance buying public in general.

4. Virginia

Virginia law on conversion is codified at §38.2-1005 and 38.2-1005.1 of the Virginia Annotated Statutes. These provisions provide that certain mutual companies and societies and domestic mutual insurers may not convert to stock companies without the approval of the State Corporation Commission. The statute refers explicitly to domestic mutual insurers with no mention of foreign mutual insurers. Therefore, Virginia would not regulate CareFirst in the conversion/merger transaction since CareFirst is not a domestic company in Virginia.

B. Case Law

There are few court cases examining the role of directors in the conversion of merger of a not-for-profit corporation. This is in part because of the swift legislative reaction to perceived self-dealing in early conversion transactions. For example, when management of Blue Cross of Ohio accepted an offer to be sold to Columbia/HCA, four executives were to receive $19 million in payouts as part of the transaction, and seven former directors were to receive $3 million. The size of these payouts raised questions about the integrity of the organization's decision-making process as well as the quality of information provided by the staff to the board. The response of several jurisdictions has been to introduce legislation prohibiting bonuses as part of such transactions.[21].

Also early in the history of such transactions, the Michigan Attorney General convinced a judge to stop a joint venture on the grounds that the public interest was not

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[21] *See, e.g.*, James Fishman, *Checkpoints on the Conversion Highway: Some Trouble Spots in the Conversion of Nonprofit Health Care Organizations to For-profit Status*, 23 J. CORP. L. 701, 718 (1998) (citing the Colorado Code which has prohibited converting corporations from going public within three years of a conversion). Usually the former nonprofit managers would own substantial sums of stock as a form of bonus, which would become enormously valuable on a public offering. *Id.* at f.n. 99.